Testimony of

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Regarding

"Early Termination Penalties"

Before the

Federal Communications Commission

On

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Chairman Martin, Commissioners Tate, McDowell, Adelstein and Copps, I appreciate the opportunity to testify before you on behalf of Consumers Union[1] (non-profit publisher of Consumer Reports).

Consumers Union is glad that the agency is investigating potential abuse of "early termination fees" (ETFs) by wireless carriers and other communications providers. We would be pleased to see the FCC take action to help wireless customers in their fight against unfair penalties. However, it would be much worse than no action at all if the agency were to grant the wireless industry's preemption petition on ETFs and take away consumers' right to sue in the process of supposedly helping them. I also hope that expanding this investigation to other industries won't delay a remedy for the problem that is most ripe—unfair penalties in the wireless industry. Accordingly, I will focus my remarks on wireless penalties.

Early termination fees are penalties designed to stop consumers from switching companies for better service and better price. Period. These penalties don't save consumers money as the carriers claim, they rob consumers of the benefits that an open and competitive market would otherwise bring. Evidence was recently presented at trial in <u>Ayyad v. Sprint</u>[2] in California that Sprint's early termination fee program actually cost them more money to implement than they recovered from it. In other words, this program doesn't save consumers money—it costs them extra.

Further, according to internal memos, the company performed one calculation and one calculation only in determining the ETF: the effect on subscriber churn.[3] That is, they didn't examine whether they fully recovered "subsidies" they offered consumers, they simply said this

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[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* regularly carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions that affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[2] <u>Ayyad v. Sprint</u>, CA Superior Court, Alameda County.

[3] According to an internal Sprint memo, the ETF program was calculated to give them a 50% reduction in churn.

will make it harder for consumers to switch. Clearly, this is about penalizing consumers for voting with their feet and pocketbooks, not about saving them money.

The wireless carriers say they want a national framework, but the truth is that they already have one. It's called the Uniform Commercial Code (UCC), and it provides standards for "liquidated damages clauses" in contracts that are the same in all 50 states. However, what the industry seeks is really nothing more than special treatment that would exempt it from the laws that all other businesses have to follow.

The Uniform Commercial Code provides an important distinction, which is the law in 50 states: it says that liquidated damages clauses *can* be used to recover actual damages, but they *cannot* be used as arbitrary penalties designed to prevent consumers from switching companies.[4] Where the carrier can prove that they have suffered actual economic harm because of subsidies they have given to the consumer, ETFs are reasonable. But the early termination penalties the wireless industry is charging consumers are so far and above the value of subsidies provided that something else is clearly going on.

There's one number I hope you'll all remember today—fourteen dollars and thirty-three cents. $14.33 is the average phone subsidy provided to the consumer according to the best data we've seen so far on carrier subsidies. In data submitted by the wireless carriers to the International Trade Commission, the average value of wireless handsets in 2006 was $115.[5] The wireless industry's trade association (CTIA) says that the average price paid for phones in 2006 was $65.67, and the carriers also charge a $35 activation fee that they treated as handset revenues on their books—for a total of $100.67 paid by the average consumer for their handset. That leaves us $14.33 in average upfront savings. Do consumers pay that off in their first month of service? Their second? Surely it does not take two full years.

If the carriers were to reduce their ETFs to $14.33—or even triple that amount—I don't think any of us would be here today asking these questions. But considering these penalties (at

[4] Cal. Civ. Code, Sections 1671(d) and 1670.5.
[5] United States International Trade Commission, U.S. Imports for Consumption. Cellphones: Customs Value by HTS Number and Customs Value for ALL Countries, 1996-2006. Available at http://dataweb.usitc.gov/.

a minimum of $175 from the two largest carriers) are more than 12 times the benefit consumers are receiving, something's fishy.

The wireless industry is quick to note that they have other costs they recoup through the ETF, namely marketing and customer acquisition costs. But should consumers really have to pay for wireless companies' advertisements? Should consumers have to bear the costs of multi-million dollar Super Bowl commercials? Do we really believe it is fair or legal to force a customer who is going to another carrier to pay for the cost of finding another subscriber for her old carrier?

The answer is clearly no. If all businesses with customer acquisition costs were to be exempted from the law of liquidated damages, there would be no law at all. Furthermore, indicators like customer acquisition costs (CAC) are simply a measure of the efficiency of a carrier's marketing operation, and are NOT a measure of any value being given to the consumer. If a wireless carrier is doing a good job of advertising one quarter, they have lower CAC; if they do a bad job the next quarter, CAC goes up. But should consumers have to pay a penalty fee related to whether the company is running effective ads or not? Again, the answer is clearly no. If the FCC is to take any action to constrain or condition ETFs, the agency must absolutely exclude advertising and marketing expenditures from the definition of a "reasonable" fee.

Perhaps the principal concern we have as consumer advocates is the way in which the agency may provide relief in the instance; we would be deeply disappointed if the FCC were to use the wireless industry's petition[6] to eliminate state oversight of these contract provisions as the vehicle for "reform" in this case. The wireless carriers are asking the FCC to reverse its policy and declare that ETFs are federally regulated, given that they now need protection from more than a billion dollars in liability from state lawsuits.[7] While we are sure that the FCC wouldn't eliminate state oversight without providing any corresponding consumer benefit, we

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[6] WT Docket No. 05-194: Petition of CTIA, the Wireless Association.
[7] See Verizon's ex parte on May 1, 2008 in Docket 05-194, which lists the lawsuits the wireless carriers would like to see eliminated through action from the FCC.

question whether companies who have been charging potentially illegal fees should receive any relief whatsoever. The agency should move quickly to deny the wireless industry's petition for a special exemption from state contract laws, and provide consumers relief using a path other than more special treatment and exemptions from the law of contracts.

We'll note in passing that the wireless industry enjoys special exemptions from federal oversight, too. If the FCC is going to take state cops off the beat, the agency should consider that consumers can't complain about these problematic fees to the Federal Trade Commission (FTC), because the wireless industry is protected from FTC oversight by the common carrier exemption.

In closing, I want to highlight one of the stories we heard earlier, from Mr. Harold Schroer. Mr. Schroer asked the FCC almost five years ago to provide some relief from undue early termination penalties. The FCC wrote back to Mr. Schroer, explaining that this was a matter of state contract law, and they had no purview over it. They encouraged him to bring it to the office of his state attorney general. The AG suggested since they didn't have the bandwidth, Mr. Schroer should consider bringing his own suit. He did just that, fighting for nearly five years to get a trial.

So here we are, five years later, and Mr. Schroer finally got his day in court. We're right in between the closing of Sprint's trial, and the opening of Verizon's trial. Enter the wireless companies, asking the FCC to "help" Mr. Schroer by eliminating his right to sue, after the agency told him that they had no jurisdiction to provide him any relief.

It is our firm hope that the FCC will do no such thing. Yes, early termination penalties are a problem for consumers and the agency or Congress should consider some reforms. But no, the price for such reforms should absolutely not be more special protections and exemptions for the wireless industry from the law of contracts.

Mr. Chairman, we are grateful for the opportunity to testify before you today, and hope to enter into a productive dialogue with you regarding potential relief for consumers on early termination penalties. Thank you.